



State Investment Commission

Monthly Meeting Minutes

Wednesday, February 27, 2013

9:00 a.m.

Room 135, State House

The Monthly Meeting of the State Investment Commission (SIC) was called to order at 9:04 a.m., Wednesday, February 27, 2013 in Room 135, State House.

I. Roll Call of Members

The following members were present: Ms. Rosemary Booth Gallogly, Mr. J Michael Costello, Mr. Thomas Fay, Mr. Robert Giudici, Ms. Marcia Reback and General Treasurer Gina Raimondo.

Also in attendance: Mr. Steve Nesbitt and Mr. Thomas Lynch of Cliffwater, alternative investment consultant to the Commission; Mr. Alan Emkin, Mr. John Burns, Mr. David Glickman and Ms. Lindsey Sugar of Pension Consulting Alliance (PCA), general policy and real estate consultant; Ms. Sally Dowling, of Adler Pollock, legal counsel; Mr. Jeff Muehlethaler and Mr. Rudy Pimentel of Pacific Investment Management Company (PIMCO); Mr. Larry Brown and Mr. Darren Lopes of TIAA-CREF; Mr. Blaise Keane, Mr. Dave Perisho and Ms. Kathy Sandstrom of Heitman; Ms. Anne-Marie Fink, chief investment officer and members of the Treasurer's staff. Treasurer Raimondo called the meeting to order at 9:04 a.m.

II. Approval of Minutes

On a motion by Mr. Giudici and seconded by Mr. Fay, it was unanimously

VOTED: To approve the draft of the minutes of the January 23, 2013 meeting of the State Investment Commission.

On a motion by Mr. Costello and seconded by Ms. Booth Gallogly, it was unanimously

VOTED: To approve the draft of the minutes of the January 25, 2013 meeting of the State Investment Commission.

III. Real Estate Update & Heitman Recommendation

Mr. Glickman recommended the committee commit \$50M into Heitman's open-end core fund. He explained it is consistent with the board's direction to add additional investments in income-producing, stabilized real estate as a way of diversifying and producing current return and this commitment will bring real estate to about 4.2% of the portfolio.

Mr. Glickman also updated the board on the fund's non-core investments. At the direction of the committee, PCA has put them up for bid, without any obligation, to sell out of smaller non-strategic positions. He explained they have asked for bids on individual partnerships and the portfolio as a whole. Ms. Sugar than updated the board on the timeline of the process.

The Heitman team introduced themselves and Ms. Sandstrom gave a brief overview on the history of the firm. She pointed out they have about 250 professionals across the world who

advise on about \$26B of real estate, mostly in North America. She explained their ownership structure and the experience and commitment of their partners. She reviewed past performance against the NCREIF where they have outperformed since inception.

Mr. Keane explained the core fund was launched in 2007 with the goal of assembling a portfolio of low-risk, high-income, well-leased properties. He said they aim to achieve the NFI_ODCE plus 100 basis points over a rolling 5-year period. He reviewed the Heitman team and committee structure.

Mr. Perisho explained their sector allocation across property types. They use a bottom-up approach and their research drives allocation of funds to where they believe growth will be. He explained they are underweight on the West Coast compared to some of their peers, but are in major markets in Chicago and Texas as well as the coasts. He said this is a very low-risk portfolio because it is 95% leased and they don't leverage a lot.

Mr. Keane gave some examples of investments and reviewed performance where 80% of projected return comes from income and only 20% from appreciation.

The committee asked questions and Heitman wrapped up their presentation.

On a motion by Ms. Booth Gallogly and seconded by Mr. Fay, it was unanimously

VOTED: to commit \$50 million to Heitman predicated on satisfactory completion of all due diligence.

IV. PIMCO & WAMCO

Ms. Fink reviewed the allocations the committee made to PIMCO and Western last meeting.

Ms. Fink brought up two discussion items: the first being whether we should consider allowing PIMCO to use modest leverage in their portfolio. The second is where the \$400M funding should come from.

Ms. Fink then reviewed the pros and cons on using leverage. She explained it would enhance returns and allow us to capitalize on low borrowing rates. Floating-rate loans would hedge floating-rate borrowing costs. It diversifies risk portfolio-wide and would create an asymmetric return profile. Further, she said PIMCO buys more highly rated securities so it is a more appropriate place to use leverage. She explained the risks including timing, default and credit risk, forced sale risk and it is a customized product.

Ms. Fink discussed a simplified illustration of the mechanics leverage. Furthermore, she explained the possible implications of leverage in various market scenarios including a recession or market crisis.

Mr. Costello asked about the structure and Ms. Fink explained triggers they could put into effect to help manage the risk.

Mr. Pimentel introduced himself and Mr. Muehlethaler and discussed when and when not to apply leverage. He explained the leverage would be at the portfolio level and PIMCO negotiates with the counterparties, but each counterparty needs to be added to the agreement and approved individually. He said, even in 2008 no one reduced PIMCO's credit lines because they invest conservatively. He also said counterparties need a year's notice before cancelling.

Ms. Booth Gallogly asked about the legal logistics of leverage and Mr. Pimentel said the fund is the named borrower. The committee discussed the legal structure at length.

Mr. Pimental then reviewed potential worst case scenarios using leverage and not using leverage.

The board decided to postpone the vote on leverage, continue funding PIMCO without leverage and conduct analysis on applying leverage.

Ms. Fink discussed how the \$200M to PIMCO and \$200 to WAMCO would be funded.

V. Alternatives Update

Mr. Nesbitt gave a brief history of the hedge fund program, which was launched about 15 months ago. He referenced page 3 of the presentation which illustrated ERSRI's global equity and real return portfolios are getting moderate returns with a relatively low level of risk. He stated the hedge fund portfolio is fulfilling its objective of getting better risk-adjusted returns. He differentiated the returns in terms of risk free rate, beta and alpha. He pointed out the focus when evaluating hedge funds is on alpha. He said the combined return of hedge funds was about 6.7%, 4.6% alpha and 2.1% from beta. Cliffwater's expectation is between 3.5%-4% of alpha and ERSRI's hedge fund portfolio is performing much better than fund of funds and even other direct hedge funds. He reviewed each manager and the composites and pointed out an information ratio above 1 is good. The composites are above 2.0 and twice of what Cliffwater expects. He pointed out hedge funds haven't been taking a lot of risk in the last year and a half.

Mr. Nesbitt provided Cliffwater's expected performance forecasts which are on par with ERSRI's CPI +400 basis points. He then explained the composite's beta exposure.

Treasurer Raimondo asked if they are concerned about any managers and if any are on their watch list. Mr. Nesbitt responded they are not worried about any of the managers except those that were redeemed. He reiterated Cliffwater and Treasury staff has a robust monitoring process.

Mr. Lynch gave a brief review of the private equity portfolio and said performance continues to be strong on an absolute and relative basis with a net IRR of 13.81%. He stated the 2006 and 2008 vintage years continue to struggle. He said there were no new commitments made in 2009 and 2010 but commitments were made in the second half of 2011 and 2012. Since then there have been 9 commitments and 8 of those 9 are already deploying capital and getting positive signs early on. He said the resuscitation of the program is off to a good start. He pointed out long-term and short-term positive managers. Mr. Lynch took questions and concluded the presentation.

VI. D/C Plan Update

Mr. Lopes explained there are \$52M in assets as of December 31, 2012 and it grows about \$10M per month. He took the board through his presentation and explained what percentage of participants are in which lifestage segment. He pointed out the lifestage does not take into consideration what they will receive from a pension. He explained TIAA-CREF's ongoing education efforts with seminars, counseling sessions and participation in different events around the state.

Mr. Lopes said about 22%-25% of the population is engaging with TIAA-CREF through phone calls and their website, which is lower than he would like, but it is getting better. Mr. Lopes expects this trend to continue.

Mr. Brown explained 8 out of 11 funds are index funds so the performance should tie closely to the benchmark and he reaffirmed this is the case. He explained some index funds are benchmarked against active managers which take on more risk.

Mr. Brown explained Vanguard will add international bonds to their bond index fund. Vanguard will also reduce the duration of their TIPS portfolio by about a year and there will be no cash allocation. He anticipated this will happen near the end of the second quarter. He also pointed out Vanguard is switching indices away from MSCI and Russell and into the FTSE and CRSP.

VII. OPEB Asset Allocation

Ms. Fink explained that on the defined benefit plan, the board has moved away from fixed income given the low returns and high risks. She explained the OPEB portfolio is 65% fixed income and 35% equity. She said the OPEB portfolio should be cash flow positive for the next decade. Given this and what the defined benefit plan is doing, Ms. Fink believes there should be more equity in the OPEB portfolio.

Mr. Emkin agrees with Ms. Fink. He recommended 65% to equity and 35% to fixed income.

On a motion by Mr. Costello and seconded by Mr. Reback, it was unanimously

VOTED: to make a recommendation to the OPEB Board to allocate 65% to equity and 35% to fixed income.

VIII. Banking Services Update

Mr. Vincent Izzo said Treasury staff is entering the implementation phase and has completed all due diligence on the banking RFPs. He explained they received 8 RFPs, all from qualified providers. He said staff is in the process of moving the disbursement bank account from Citizens Bank to Sovereign Bank, which will save on fees. He said the earnings credits to offset fees were near the best and on any excess balances Sovereign will pay the investment rate. All the proposals from the other banks also lowered rates and the RFP process should save the state around \$300,000 a year in banking fees. Mr. Izzo said staff evaluates banks on a monthly basis, but there hasn't been a formal RFP done in a while and it turned out to be a valuable exercise.

IX. 457 Plan Update

Mr. Mark Rhoads, Treasury staffer, gave a review of the 457 Plan's progress the past 6 months, a few highlights on each fund individually, and goals going forward.

He briefly reviewed the changes the SIC made in June of 2012 including lowering administrative fees, and the addition of index and lifecycle/target date funds.

He explained Treasury has worked with the Department of Administration in outreach efforts to get the providers on site for recruitment and education efforts. He pointed out the 457

plans assets are growing, partly because of the recent market run up, and also because there are about 100 new participants in the plan in 2012. He explained Valic is only slightly losing some participants, Fidelity is remaining steady and ING's participant base is growing. Mr. Rhoads pointed out the average balance of a participant in ING was about \$30,000, \$50,000 in Fidelity and \$40,000 in Valic. He said there are about 6,000 participants which is a good participation rate, but he would like to see those numbers increase. He reviewed each lineups performance and noted there is significant movement into the target date funds and the new index funds. He gave a brief update on the Valic stable value fund explaining that all participants are at the 3% floor until the issue is resolved. He gave a brief updates on goals moving forward.

XI. Legal Counsel Report

There was no legal report.

XII. CIO Report

Ms. Fink reviewed performance for the month and said it is in line with our benchmark, but the private equity performance lags, which affects the total performance. She explained the decision to reduce fixed income paid off this month.

She gave a brief update on the infrastructure RFI and explained she has recused herself from the process out of caution because her former employer was a respondent. Treasurer Raimondo said she would oversee the RFI review team during the process.

Ms. Fink gave an update on corporate governance and is expected to be back next month with a more extensive plan.

Mr. Lynch gave a brief update on the firearms situation in one of the portfolio's private equity funds and answered Treasurer Raimondo's questions on the issue.

Ms. Fink pointed out the end of February has been volatile so far and explained she reduced the equity overweights from appreciation.

XIII. Treasurer's Report

There was no Treasurer's report.

XIV. Adjournment

There being no other business to come before the Board, on a motion by Ms. Booth Gallogly and seconded by Mr. Fay, the meeting adjourned at 11:31 a.m.

Respectfully submitted,



Gina M. Raimondo
General Treasurer